BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FEDERAL LAND AND DEVELOPMENT COMPANY)

Appearances:

For Appellant: Wells A. Rathbun, its President

For Respondent: Chas. J. McColgan, Franchise Tax Commissione
Frank M. Keesling, Franchise Tax Counsel;
Clyde Bondeson, Senior Franchise Tax Auditor

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Federal Land and Development Company to his proposed assessment of an additional tax in the amount of $70.06 for the year ended December 31, 1936, based upon the income of the company for the year ended December 31, 1935.

In its return of income for the year 1935, the Appellant deducted from its gross income the amount of $2,203.95 as a loss arising from a certain Foothill Vineyard Acres transaction and the amount of $5,583.87 as a reserve for bad debts. The Commissioner disallowed the amount deducted as a reserve for bad debts and levied his proposed assessment. Following the consideration of the taxpayer's protest, the Commissioner allowed the deduction of the amount of the reserve for bad debts, but disallowed the deduction of the loss arising from the Foothill Vineyard Acres transaction and revised his proposed assessment accordingly. The taxpayer then appealed to this Board from the action of the Commissioner.

At the hearing of the appeal the Appellant conceded the correctness of the Commissioner's position with respect to the loss arising from the Foothill Vineyard Acres transaction, but contended that no additional tax was due by reason of the fact that it was entitled to an additional deduction for bad debts in an amount which, if allowed, would result in the sustaining of a loss from its operations during the year. The Appellant argued that in 1935 it had no prior experience to guide it in estimating its probably losses from bad debts, that while at the time ten per cent of the outstanding, accounts receivable was believed a reasonable amount to charge to a reserve for bad debts, such amount was in fact wholly inadequate, the accounts receivable on the books at December 31, 1935, which proved worthless amounting to $10,462.56 in excess of the amount charge to the reserve for bad debts.

Section 8(e) of the Bank and Corporation Franchise Tax Act authorizes the deduction from gross income of "Debts ascertained to be worthless and charged off within the income year, or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts." It is not apparent from the Appellant's contention whether it is proceeding upon the theory that it is entitled at this time to increase the amount of its reserve for bad debts for 1935 or upon the theory that it is entitled to deduct the aggregate amount of the debts which proved worthless during the year. The Appellant must, however, follow one of the two methods prescribed by the Act in claiming its deduction for bad debts. A charge must be made for the specific debts claimed to be worthless or the reserve method must be employed, both methods may not be used by the Appellant for the year. Atlantic Bank & Trust Co. v. Commissioner of Internal Revenue, 59 F. (2d) 363; Rogers Peet Co. v. Commissioner of Internal Revenue, 21 B.T.A.577; *see* also Athol Manufacturing Co. v. Commissioner of Internal Revenue, 54 F. (2d) 230. Which ever method be followed, however, the Appellant's position is unsound

Even though it be assumed that the Appellant ascertained the worthlessness of all the debts in question during 1935 and that the establishing of the reserve for bad debts might be regarded as equivalent to the charging off of certain debts during the year (see Rhode Island Hospital Trust Co. v. Commissioner of Internal Revenue, 29 F. (2d) 339), an additional deduction for specific debts is not available to it for the year inasmuch as it has failed to comply with *one* of the statutory requirements for the deduction, viz., the charging off of those debts during the year, Peerless Oil & Gas Co. v. Heiner, 81 F. (2d) 391, cert. den. 299 U.S. 545; Fairless v. Commissioner of Internal Revenue, 67 F. (2d) 475.

The elimination of a debt as an asset is indispensable to an effective charging off of the debt. Brown v. United States, 19 F. Supp. 825. This principle is equally applicable to cases in which the reserve method is employed, the deduction of the amount of the reserve being then substituted for the elimination of specific debts, and the application of the principle to those cases precludes the increasing by the taxpayer of the reserve for bad debts for a given year at some time after the closing of the taxpayer's books for that year. In the case of Farmville Oil & Fertilizer Co. v. Commissioner of Internal Revenue, 78 F. (2d) 83, the Court rejected the taxpayer's contention that it might, at a later date, increase the amount added to its reserve for bad debts for a given year, stating as follows:

> "Furthermore, the realization by the taxpayer long after the close of the taxable year that its reserve for bad debts during that year was insufficient does not justify its enlargement retroactively. The statute allows a deduction for bad debts if ascertained to be worthless and charged off within the year, or, in the alternative, a reasonable addition to a reserve for bad debts in the discretion of the Commissioner. We do not think that Congress meant that the amount of the reserve might be

increased by the taxpayer long after the taxable year had expired, while limiting deductions for debts charged off to those actually ascertained to be worthless and charged off within the year.

"Doubtless, under proper circumstances, the correctness of the taxpayer's estimate in fixing the amount to be added to the reserve in any year may be supported by reference to the losses actually incurred in subsequent years, as was held in Peyton Du-Pont Securities Co. v. Commissioner (C.C.A.) 66 F. (2d) 718; or the failure of the taxpayer during the taxable year to observe the proper technical procedure in claiming a deduction maybe overlooked; as in Rhode Island Hospital Trust Co. v. Commissioner (C.C.A.) 29 F. (2d) 339; but estimates fairly made at the time may not be enlarged in the light of subsequent events; for then the reserve would cease to be a true reserve, and the taxpayer, contrary to the spirit of the statute, would be permitted to deduct worthless debts in a year prior to that in which their worthlessness would be realized. Such a result would be entirely out of harmony with our taxing system, which was designed to produce revenue, ascertainable and, payable to the government at regular annual intervals, based upon the net result of the taxpayer's operations within the taxable year. Burnet v. Sanford & Brooks Co., 282 U.S. 259, 51 S. Ct. 150, 75 L. Ed. 383." 78 F. (2d) 84.

We are accordingly of the opinion that the Appellant is not entitled to a deduction for bad debts or for a reserve for bad debts in excess of the amount of the reserve for bad debts set forth in its accounts and in its return of income for the year ended December 31, 1935, and that the action of the Commissioner should be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Federal Land and Development Company to a proposed assessment of an additional tax in the amount of $70.00 for the year ended December 31, 1936, based upon the income of said company for the year ended December 31, 1935, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of April, 1938, by the State Board of Equalization.

R. E. Collins, Chairman
Fred E. Stewart, Member
Jno. C. Corbett, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary